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AGENDA ITEM: 8e

TO: MEMBERS OF THE INVESTMENT COMMITTEE

- I. SUBJECT:** Corporate Governance Environmental Strategic Plan Update
- II. PROGRAM:** Global Equity
- III. INFORMATION:** Information Only
- IV. ANALYSIS:**

Executive Summary

This agenda item provides an update on staff's progress in implementing the Corporate Governance Environmental Strategy ("Strategy") and participation in INCR including addressing the 10 items of INCR's Call for Action (Attachment 1).

The objective for both the Strategy and INCR's Call for Action is to improve environmental data transparency and timely disclosure. As part of CalPERS' continued commitment to improving environmental data transparency and timely disclosure, staff will maintain its efforts as summarized by the following next steps:

- Corporate Governance Principle & Guideline Addition
- Company Engagement
- Transition Utilities GHG Reporting Project to Company Engagement
- Carbon Disclosure Project
- Continue Leadership Position in INCR

Background

In 2004, CalPERS was asked by California State Treasurer Phil Angelides and California State Controller Steve Westly to consider environmental issues with respect to the potential impact on the Fund. Further, CalPERS was asked to take an active role in encouraging companies to provide meaningful, consistent, and robust reporting of their environmental practices, risks, and potential liabilities. After exploring the issue, staff believed that improved data transparency could help long-term risk assessment at the companies in which CalPERS invests. Therefore, four targeted initiatives were identified to facilitate improving environmental data transparency.

On February 14, 2005, the Investment Committee approved the Corporate Governance Environmental Strategy and directed staff to proceed with four initiatives outlined as follows:

- 1) Sign onto the Carbon Disclosure Project.
- 2) Support GHG data transparency within the auto industry, including support of shareholder proposals and potential Focus List candidates.
- 3) Explore opportunities to improve GHG data transparency within the electric power/utilities industry.
- 4) Recognize corporate disclosure "Best Practices".

On June 13, 2005, staff presented the Investment Committee with an update on staff's progress of implementing the four initiatives.

On May 16, 2005 per staff's request, the Investment Committee directed staff to have CalPERS listed as a signatory on INCR's Call for Action (Attachment 1). The Call for Action is a ten-point action plan focusing on four targeted sectors to address the financial risks and investment opportunities posed by climate change. On August 15, 2005, staff provided the Investment Committee with information on how CalPERS would respond to each of the ten points, and while the signatories are encouraged to act on each action point, they are not required to do so.

With regard to Initiative 3 of the Corporate Governance Environmental Strategy, Staff presented a three part recommendation for a greenhouse gas (GHG) reporting project to the Investment Committee on September 19, 2005. The Investment Committee approved the recommendation and directed staff to proceed with the GHG reporting project.

Recent Supporting Events

In November 2005, Goldman Sachs released its environmental policy framework (Attachment 2) in which it identified the company's policy and explained how each of the company's major business areas will integrate it. Goldman Sachs not only committed to disclose the environmental impact of its operations and to reduce those impacts including reducing its indirect GHG emission but the company also stated that it will increase its commitment to systematically incorporate environmental, social and governance criteria into fundamental analysis of companies. Goldman Sachs also addressed the need for public policy and its belief that government can help capital markets by establishing a strong policy framework that creates long-term value for GHG emission reductions and consistently supports the development of new technologies that lead to less carbon-intensive economy. Based on its belief, Goldman Sachs identified a set of principles that should guide public policy development.

At the Montreal 2005 United Nations Climate Change Conference that took place over a two week period from November 29 to December 10, 2005, the delegates including the United States adopted more than 40 decisions. Among the decisions was the adoption of the Marrakech Accords, which is essentially the "Kyoto Rule Book," that will allow the countries under the Kyoto Protocol to begin formally implementing the Protocol. In addition, the delegates agreed to open a dialogue on long-term cooperative action to address climate change.

On January 18, 2006, six former administrators of the Environmental Protection Agency (EPA) participated in a roundtable discussion to celebrate EPA's 35th anniversary and they all maintained that there should be mandatory controls on GHG emissions including carbon dioxide. Lee M. Thomas, who headed the agency from 1985 to 1989, said that U.S. businesses would welcome federal regulation at this point because it would allow them to plan for the kind of investments that will be needed to cut carbon dioxide emission linked to climate change. However, the current administrator, Stephen L. Johnson stated that the current plan is to pursue voluntary emission reductions and technological innovation rather than requiring mandatory cuts.

On January 31, 2006 in the State of the Union address, President Bush announced the Advanced Energy Initiative at the Department of Energy calling for a 22% increase in clean-energy research including the investment in zero-emission coal-fired plants, revolutionary solar and wind technologies and clean, safe nuclear energy. President Bush also spoke of his plan to increase research in better batteries for hybrid and electric cars, pollution-free cars that run on hydrogen, and in cutting-edge methods of producing ethanol in an attempt to reach his goal of replacing more than 75% of our oil imports from the Middle East by 2025.

Update – Corporate Governance Environmental Initiatives

Initiative 1: Support – Carbon Disclosure Project (CDP)

The objective of Initiative 1 was to support the CDP by becoming a signatory on a reminder letter (Attachment 3) that was sent on April 1, 2005 to the Financial Times 500 (FT500) companies requesting they respond to CDP's 2005 questionnaire (CDP3). The CDP3 was originally mailed to the FT500 companies on February 1, 2005. CalPERS became a signatory along with 154 other institutional investors representing more than \$21 trillion in assets under management. The FT500 companies had until May 31, 2005 to respond.

In September 2005, CDP issued its 2005 report summarizing the company responses. The executive summary of the 2005 report can be found in Attachment 4. CDP reported a response rate of 71%, up from 59% in CDP2 and 47% in CDP1. Beginning with CDP2 and based entirely on the responses, CDP created a Climate Leadership Index (CLI) using a defined selection process for CDP2 and CDP3 that contains the "best in class" responses. An example of a "best in class" response (BP) can be found in Attachment 5. BP has been selected for the CLI for both CDP2 and CDP3. The CLI consisted of 50 companies for CDP2 and 60 companies for CDP3 due to the increased response rate. Attachment 6 includes the 60 companies selected for the CLI in CDP3.

CalPERS continues to support CDP and provided input during the comment period for CDP's 2006 information request (CDP4), which was incorporated into CDP4 (Attachment 7). CalPERS was one of 211 institutional investor signatories representing \$31 trillion in assets under management on CDP4. The additional signatories represent an increase of 38% and a 48% increase in assets under management over CDP3.

Not only has support for the CDP grown, but so has the project itself. On February 1, 2006, the CDP4 was mailed to 1,800 of the largest quoted companies in the world based on market capitalization. The 1,300 additional companies represent new partnerships with groups such as The Conference Board of Canada, German Investment and Asset Management Association, and CalPERS and the California State Teachers Retirement System (CalSTRS). As part of CalPERS' initiative to improve data transparency within the electric power / utilities (Utilities) industry, which is discussed below in Initiative 3, the CDP4 was mailed to 258 global Utilities companies, including CalPERS global Utilities portfolio companies, in collaboration with CalSTRS and CDP.

The responses to CDP4 are due on May 31, 2006 and CDP anticipates issuing its 2006 report in September 2006. The company responses will be made available to the public on the CDP website when the 2006 report is released.

Initiative 2: Improve Data Transparency – Auto Industry

The objective of Initiative 2 was to improve environmental data transparency and timely disclosure in the auto industry. Staff identified shareowner resolutions filed at Ford and General Motors (Attachment 8) that would facilitate the improvement of data transparency and timely disclosure without posing long-term harm to either company. In addition to voting “For” the shareowner resolutions, the Investment Committee also directed staff to hire a proxy solicitor to garner additional support.

On March 31, 2005, Ford announced its plans to issue a report on climate change and as a result the co-filers withdrew their proposal. Ford released its report, “Ford Report on the Business Impact of Climate Change” (Attachment 9), in December 2005. In addition to improving environmental data transparency and timely disclosure, Ford also demonstrated its responsiveness to shareowners by issuing a report addressing the merits of the shareowner resolution. Ford’s response regarding its plans to comply with California’s GHG standards can be found in Appendix 2 of the report. Ford also communicated its commitment to the issue of climate change and intention to “participate fully in the larger public dialogue on actions required by governments, businesses and individuals to address climate change concerns.”

Ford and General Motors have both received all three CDP questionnaires and both have responded to each one. Ford has been selected for the CLI for both CDP2 and CDP3. The other auto companies selected for the CDP3 CLI are BMW, Daimler Chrysler, Honda, and Toyota.

General Motors was unable to come to a resolution with the co-filers of its shareowner proposal. Therefore, consistent with the Investment Committee’s direction, CalPERS in a joint effort with CalSTRS submitted a letter to the company’s Board of Directors communicating our strong support of the proposal and requesting the company comply with the proposal’s request (Attachment 10). CalPERS also hired a proxy solicitor to solicit additional support for the shareowner resolution.

Initiative 3: Improve Data Transparency – Electric Power/Utilities Industry

The objective of Initiative 3 was to work together with CalSTRS to explore the viability and development of a GHG reporting project that focuses on improving adequate, accurate and timely data transparency within the Utilities industry.

On September 19, 2005, the Investment Committee approved staff’s recommendation for 1) a greenhouse gas (GHG) reporting project to be done in coordination with CalSTRS and CDP with the objective to improve transparency

in the Utilities industry, 2) writing letters to CalPERS' Utilities portfolio companies to encourage cooperation with the GHG reporting project and consider other forms of disclosure in regard to GHG reporting, and 3) publicly recognizing the companies that cooperate with the GHG reporting project.

Staff has worked closely with CalSTRS and CDP to implement the project which included drafting a section specific to the Utilities industry that would be included in CDP4. The Utilities section is in addition to the other input staff provided to CDP for the CDP4. The Utilities section was included in the version that was sent to the 258 largest Utilities globally based on market capitalization, including CalPERS global portfolio Utilities holdings. As stated above, the CDP4 was mailed to the companies on February 1, 2006 and had the support of 211 institutional investors.

Consistent with Board approval, staff sent letters to CalPERS' Utilities portfolio companies expressing CalPERS' strong support for the CDP4 and encouraging the companies to respond to it as well as to consider other forms of disclosure. Attachment 11 contains a copy of the letter sent to those companies that are held in CalPERS' portfolio. Attachment 12 contains a list of CalPERS' Utilities companies that received the letter.

The companies have until May 31, 2006 to respond to the CDP4. CalPERS will continue to communicate with CalSTRS and CDP in order to track the progress of the GHG reporting project and monitor the responses that CDP receives. Once CDP posts the responses to its website and releases them to the public, CalPERS will publicly recognize on CalPERS' website those Utilities portfolio companies that responded to the CDP4. Additionally, CalPERS will provide a link to CDP's website where interested parties can go to view the companies' responses. Staff anticipates the responses to be publicly released in September 2006.

Update – Investor Network on Climate Risk (INCR)

Call To Action

In December, CalPERS was a signatory along with 19 other institutional investors representing over \$800 Billion in assets under management on a letter that was sent to the 30 largest U.S.-based insurance companies. Climate risk disclosure in the insurance industry has been virtually non-existent. The letter asked those companies to undertake a comprehensive analysis of the business implications of climate change and report the findings of that analysis to shareowners. The letter supports Item 2 of INCR's Call for Action, which is

“Support for and success of appropriate shareholder resolutions and company engagement to improve corporate disclosure and governance on climate risk.”

In addition to the letter to the insurance companies, staff will continue supporting shareowner resolutions that attempt to improve data transparency and timely disclosure of environmental data without posing any long-term harm to the company such as those filed at Ford and General Motors in 2005. Staff is currently aware of shareowner resolutions that have been filed at some Utilities companies and will support the resolutions by voting “For” them.

On April 5-6, 2006, Ceres will hold a conference on Accelerating Sustainable Governance in Oakland, California. The conference is expected to bring together corporate directors, CEOs, national environmental leaders, investors and corporate governance experts to discuss how sustainable governance builds shareholder value and promotes lasting prosperity. Staff will participate on a climate risk disclosure panel at the conference and will share CalPERS’ work with INCR, how CalPERS is addressing the 10 Action Items of INCR’s Call for Action, and CalPERS collaboration with CalSTRS and CDP on the Utilities GHG reporting project. The panel as well as the Ceres conference supports Item 4 of INCR’s Call to Action, which is to promote information sharing among the growing number institutional investors and organizations around the world concerned about climate risk.

In July 2005, CalPERS was one of 15 signatories representing more than \$550 Billion in assets under management on a letter that was sent to 43 of the country’s 50 largest investor-owned GHG emitters in the industry. The letter requested that the companies report within a year how future GHG limits will affect their financial bottom lines and any steps they are taking to reduce those financial impacts and improve their competitive positioning. The letter supports Item 7 of INCR’s Call for Action, which calls for Utilities companies to provide more disclosure of climate risk and its impact on the companies’ competitiveness and investment returns. Among the responses received to date, five companies have indicated that they intend to issue reports and three companies have indicated that they plan to issue reports in response to shareowner resolutions. INCR is still in the process of contacting companies who have not yet responded to the investors’ request.

Staff assisted INCR with the development of a “Corporate Governance Score Card on Climate Risk” (Scorecard) by reviewing both the methodology and checklist and providing feedback. The Scorecard is an annual corporate governance scorecard of 100 large emitters of GHGs and it is expected to be released by March 2006.

Council of Institutional Investors (CII) Breakfast

CalPERS, CalSTRS, the Office of the Connecticut State Treasurer, and the Office of the New York City Comptroller will be hosting a breakfast session on “Corporate Governance and Climate Risk: What Investors Can Do to Protect and Enhance Shareholder Value” at the Spring CII meeting. All CII members will be invited to the session which will take place on Thursday, March 30, from 7:30-8:45 a.m. A substantial portion of the breakfast session will be dedicated to recognizing INCR leaders who have taken action to protect and enhance shareowner value through environmental initiatives.

Next Steps – CalPERS Corporate Governance Environmental Strategy

Corporate Governance Core Principle & Guidelines Addition

In order to support the Corporate Governance Environmental Strategy’s objective of improving environmental data transparency and timely disclosure, staff has proposed the addition of an environmentally focused principle to the CalPERS Corporate Governance Core Principle & Guidelines. The proposed principle addresses environmental disclosure and reads as follows:

“To ensure sustainable long-term returns, companies should provide accurate and timely disclosure of environmental risks, such as those associated with climate change.”

The proposed amendment will demonstrate CalPERS’ commitment to the Corporate Governance Environmental Strategy while supporting staff’s ability to vote in favor of future shareowner proposals supporting accurate and timely disclosure of environmental risks.

Company Engagement

Utilizing multiple sources, staff will identify a targeted number of companies in the transportation, utilities, and oil and gas sectors that are either not disclosing any environmental data or whose disclosure does not meet a pre-determined minimum standard. It is anticipated that the confidential engagement process would include written correspondence, engaging in dialogue and possibly filing shareowner resolutions. Should staff determine that filing a shareowner resolution at one or more of the companies is warranted, staff will consider various options in which to solicit support for the resolution including hiring a proxy solicitor.

Staff will work closely with CalPERS’ proxy voting staff to identify companies with shareowner resolutions requesting improved environmental disclosure and the

frequency with which the resolution has appeared in the proxy to determine the company's responsiveness to shareowners. Staff may also be able to identify potential candidates for engagement via its participation in INCR. As a steering committee member, CalPERS participates in meetings during which the members often discuss various companies and their current disclosure practices. Furthermore, INCR's soon to be released Scorecard will provide staff with yet another source to identify two to three companies for possible engagement.

Staff's objective in this targeted engagement initiative will be to improve accurate and timely disclosure of environmental risks, such as those associated with climate change, at CalPERS' portfolio companies.

Transition Utilities GHG Reporting Project in to Company Engagement

Staff will transition the utilities GHG reporting project over to its company engagement initiative. Staff will identify those portfolio utilities companies that did not respond to the CDP4 and elevate them for consideration as candidates for engagement.

Carbon Disclosure Project

Staff will monitor CDP's progress with the CDP4 and the subsequent release of its 2006 report. Those portfolio companies in the transportation, utilities, and oil and gas sectors that do not respond to the CDP4 will be considered for possible engagement. In addition, staff will continue its support of the Carbon Disclosure Project and will evaluate the opportunity to have CalPERS be a signatory on CDP's 2007 questionnaire at the appropriate time.

Continue Leadership Position in INCR

Staff will continue to maintain its leadership position in INCR as a Steering Committee Member in order to meet CalPERS' objective of improved environmental data transparency and timely disclosure to assist shareowners in making more informed investment decisions.

Annual Update

Staff plans to update the Investment Committee again in the spring of 2007.

V. STRATEGIC PLAN:

This item is consistent with the Strategic Plan: Goal 1, exercise global leadership to ensure the sustainability of CalPERS' pension and health benefit systems. This item is a product of the 2005-2006 Global Equity Annual Plan.

VI. RESULTS/COSTS:

Costs associated with the Corporate Governance Environmental Strategy are absorbed by the current Investment Office budget.

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